

Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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Page 1

PRICE MOVEMENTS. The last two Letters discussed the possibility of a full correction of the June-July (T to X) decline. This correction has materialized, and the advance from X has (as of this writing) retraced about 50% of the losses sustained by both Averages since T. Should the correction continue, an advance to around 638 on Industrials and 141 on Rails would still fall within the normal 1/3 to 2/3 retracement to which every movement (whether primary, secondary or minor) is entitled.

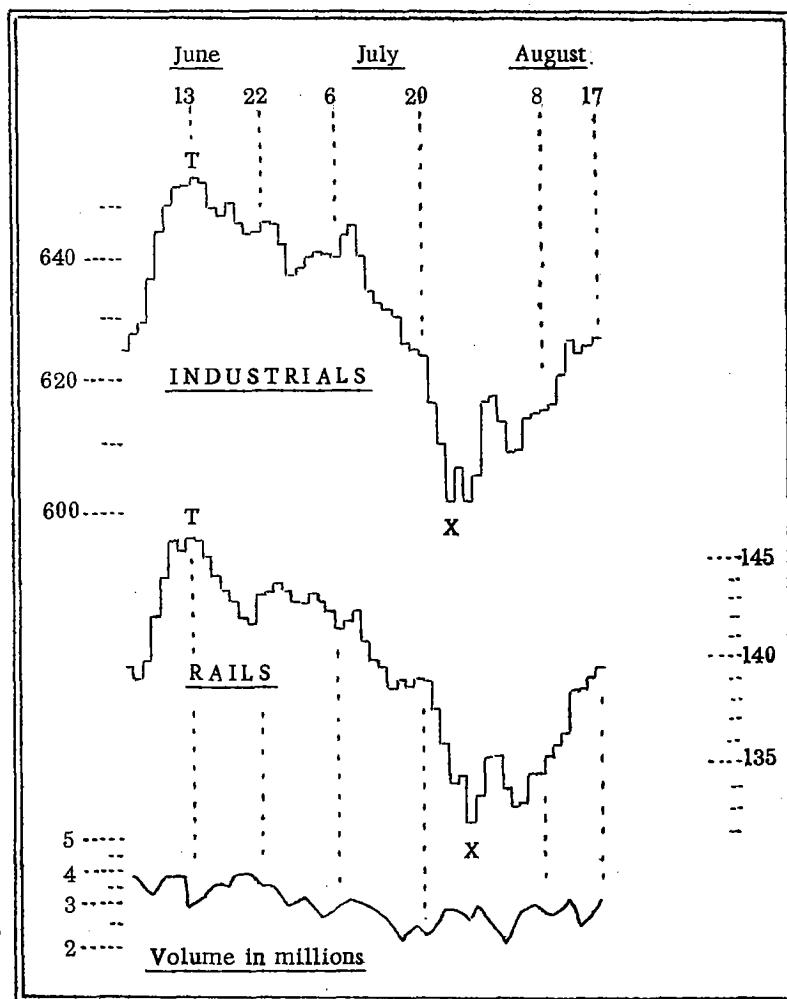
The Industrial Average has risen on 13 of the last 17 trading days, the Rails have moved higher on 12 of the last 15 trading days. The preponderance of total issues which have advanced (as against those which have declined) during the last 17 days has been excessive. Both of these factors suggest that the market is rapidly becoming "over-bought" and that a downward movement (of at least minor proportions) is overdue.

A decline of a few days or so followed by an upward zig-zag in both Averages (on increasing volume) would give heart to the bulls. On the downside the only point of real importance is the 599.10 Industrial low which was established on March 8, 1960. A breaking of this low would reaffirm the primary bear trend; it would also be a prediction of a further and perhaps drastic deterioration in business.

MANIPULATING THE PRIMARY TREND

Three months after the "Soaring Sixties" were ushered in, Dow's Theory signalled a primary bear market. With what seemed like a single voice market experts and financial writers from coast to coast denounced the "antiquated Dow Theory" and the "false bear signal". Business and Governmental leaders literally fell over themselves in their haste to announce that all was well. "We were too optimistic in January," they admitted in retrospect, "but the economy will surge as soon as inventories are worked off in June and July".

Then, despite the rash of hopeful statements, a strange series of events occurred. During a six month period the Federal Reserve Board saw fit to (1) lower the discount rate from 4% to 3 1/2%, (2) lower stock margins from 90% to 70%, (3) lower bank reserve requirements, and (4) again lower the discount rate, this time from 3 1/2% to 3%. Last week a Reserve Board spokesman (with characteristic restraint) was quoted to the effect that "inflation-



ary dangers have continued to lessen since June". Less kindly observers were putting it another way; "the Fed," they said, "has opened the floodgates again".

During the recession of 1957-58 the "floodgate" procedure worked. The economy was then in the second phase of a great bull market, and the primary trend was up. The pumps were primed, inflation was resorted to, and the Government ran up its famous 12 billion dollar deficit. The boom phase of the bull market was on.

But there is a difference today. The primary trend is now down, and the tide is running against business. Whether the Federal Reserve can manipulate the primary trend remains to be seen; this observer does not believe it can be done. Rhea did not believe the tide could be manipulated, and during the 1937-38 bear market he warned his subscribers as follows:

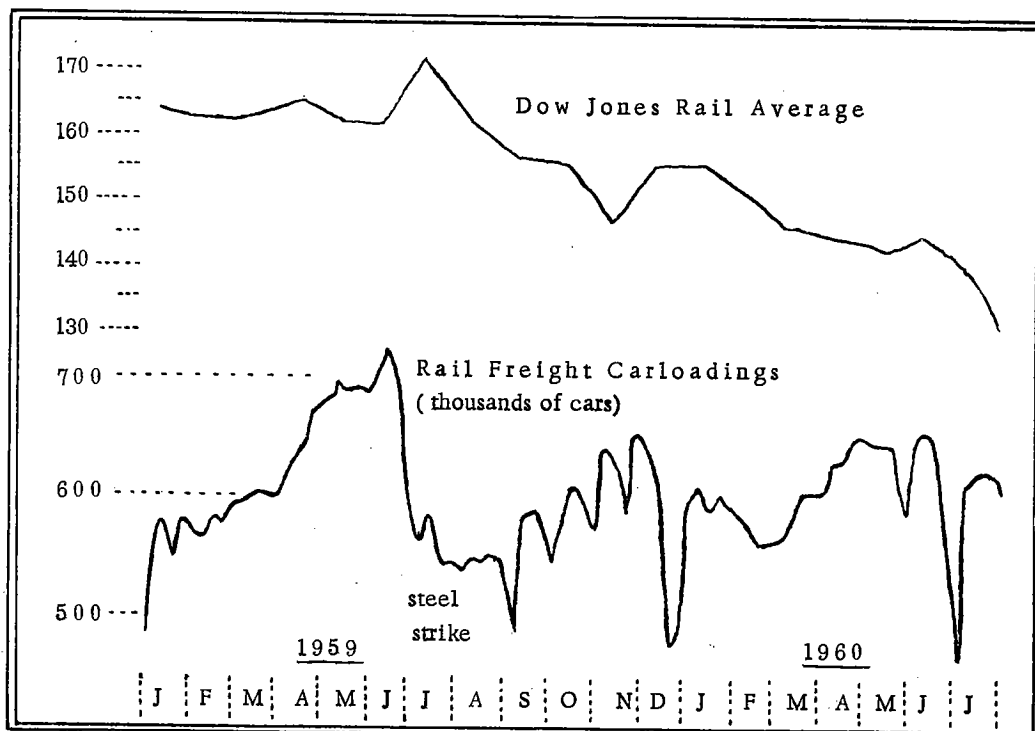
"Dow's Theory pays no attention whatever to the wishful thinking of industrial leaders as expressed in bullish pronouncements; it makes little of Presidential scoldings. The primary trend of business and stock prices cannot be 'talked up' or 'forced down' by the President, by Congress, or by any single man or group of men. The primary force is generated only by the willingness and ability on the part of people here and elsewhere in the world to buy or not to buy. The desire to buy might be artificially induced, but ability to buy is a by-product of thrift and industry."

Again Rhea observed (September 27, 1937) "Easy money was no boon to the market in the 1929-32 period. Remember how the market crashed each time a paternalistic move was made by Mr. Hoover? Government with all its power, can't control even the Mississippi River, much less the tides of American business or sentiment. Government money policies, if constructive, can help a bull market but can't stop a bear trend."

RAILS AND CARLOADINGS Financial columnists (most of whom have made little or no study of the subject) have been belittling the Rail Average ever since it gave its half of a bear signal on March 3, 1960. The accompanying chart may throw some light on the subject of the Rail Average and whether the movements of that Average are meaningful or not. The chart traces the January, 1959 - July, 1960 movements of the Rails, and these are superimposed upon the actual carloading figures for the same period.

Every boom in modern history has been a capital goods boom; every movement of capital goods has been dependent to a great extent upon the rails. The rails now handle almost half of this nation's inter-city traffic; moreover, they carry a high percentage of the "cargo that counts" (steel, metal parts, coal, etc.)

Referring to the chart, we see that the Rail Average had been working higher throughout the early part of 1959; the Average hit its high of 173.56 in July, 1959. During the same period



rail carloadings had been steadily increasing, and they touched their peak in late June, 1959. The July-September slump in carloadings came as no surprise to the market since the drop was largely a result of the steel strike. As it became apparent that the steel strike was not going to end quickly, the Rail Average continued the retreat which had begun in July.

But during the latter part of 1959 there was widespread talk about a boom in manufacturing and shipping which was to occur after the steel strike. So thoroughly was this thesis believed, in fact, that manufacturers prepared for the mythical boom by ordering large stocks of raw materials while putting great quantities of finished goods into their own inventory.

In view of the "coming boom", however, it was strange that the Rail Average began plotting a long series of descending highs and lows. If there was to be a boom, asked Dow Theorists, why weren't the Rails moving up to discount it? The answer was unpleasant but self-evident. The Rail Average was saying that the peak in carloadings had been seen in mid-1959.

In March, 1960, the bear signal was given as Rails broke under their November, 1959, low point of 146.65, thereby confirming the Industrial penetration of 616.45 (the comparable Industrial low point). In so doing, the two Averages were saying that the peak in both manufacturing and shipping had been seen for a long time to come.

TWO FRIENDS meet; one is a bull and the other is a bear. Having exhausted the subject of politics the week before, their talk now turns (perhaps out of desperation) to the stock market. THE BULL speaks; "I'll admit it. The profit squeeze is on. Anybody who can read the papers knows that corporate statements are fair to poor, the steel rate is depressing, competition is getting very rough, the boys don't want to build inventories because they can get immediate delivery on just about anything. Appliances aren't moving, used and new car inventories are a fright, gold is flying out of the country. I'll grant you all this, but why don't you tell me something new. Look -- the market has absorbed all the well-advertised bearish facts; the Industrials have bounced off the 599.10 level on three major attempts, and they don't seem to want to go through. Frankly, I think the worst has been seen, and the market is saying that things are going to get better. Sure -- most stocks have taken a pasting over the last year, but your blessed Industrial Average is holding. The longer it holds, the better the chances that it won't go through, correct?"

THE BEAR SAYS "Maybe, but 'triple bottoms' in bear markets are like promises; they're made to be broken. Remember the impenetrable triple-top of 1956-57? And if I may, I'll pull a switch on your final statement. What you say about Industrials' holding is true in a bull market, but the Averages have given a bear signal, and this is a bear market. Therefore, the longer the two Averages resist going through their highs, the less the odds favor such a possibility -- and it's been a year now since the highs. Besides, there have been plenty of similar situations in the past when you bulls guessed that the market had discounted the worst. Remember the great rally of November, 1929 to April, 1930? Remember how bullish everybody was when the Industrials swung back from 198 to 294? General Electric even hit a new high above its 1929 peak on that swing. Why it's in the nature of a bear market to keep the bulls hanging onto their stocks until it's too late. All this triple-bottom is doing is giving you bulls back your confidence. Then just about the time you're convinced that the 599.10 point is sacred, the Industrials are going to plunge through. And as far as your run-down on the bad news is concerned, you haven't heard any bad news. This bear market's still a baby; all we know is that it's in the process of correcting the greatest bull market in history. When 599.10 is cracked, you're going to hear so much bad news you'll think today's newspaper is a description of paradise. Listen, if investors really believed the current bad news those Averages would have gone down on real volume in January and July. Nobody's sold any impressive amount of stock yet, but they will -- just as soon as we get a little nearer to where the bad news is ready to appear."

THE BULL puts his arm around his friend's shoulder. "Listen, we're pals, but I hope you're not repeating this nonsense to anybody else...."

OBSERVATIONS Because a large percentage of my subscribers are businessmen or corporate executives, I have tried to stress the fact that Dow's Theory concerns itself with a good deal more than the stock market alone. Stock prices merely reflect the future condition of business. When the primary trend turns up or down, it affects everything -- commodity prices, stock prices,

profits, employment, capital outlays, etc. In view of this it is interesting to read the following quote from August 17th's Journal of Commerce: "A few years ago, prices of the more sensitive commodities undoubtedly would have bounded upward on the recent Federal Reserve Board announcement of monetary ease. Instead, they have continued to give way under the impact of large supplies and somewhat sluggish demand."

A further comment is provided by Dr. Charles T. Taylor of the Federal Reserve Board of Atlanta: "Prices now move up and down in response to current supply and demand situations, not to general inflationary pressures."

EXODUS Today it was announced that the U. S. gold stock had dropped another 50 million. This reduced the total U. S. Gold supply to \$19,032 million, the lowest level in twenty years or since early 1940.

SWING LOW Many individual stocks and even groups have been in sustained downtrends for a year to a few years. Three groups which topped out before the July, 1959, bull market top are aircrafts, oils and coppers. Many stocks have dropped so drastically that they are now overdue for technical corrections. As a rule of thumb, when a stock loses 50% of its value without an upward correction, it is overdue for a rally. For this reason I prefer not to short stocks which have fallen 50% or more in straight line moves.

Many investment services have recently recommended Magma Copper as a "buy". This volatile stock hit its bull market high of 139 in 1956, but by January, 1958, it had crumbled to 31 7/8. A major correction advanced Magma to 78 in March of 1959; four months later the bull market hit its peak.

By May, 1960, Magma had dropped to a low of 34 1/4, a 56% loss in a period of 14 months. This suggested that Magma may have gone down too far and too fast. As seen on the chart, Magma's price movements were beginning to suggest an area of accumulation beginning around March, 1960. A rather complex "head-and-shoulders bottom" was forming, and the pattern seemed to be completed in August. The left shoulder (A) bottomed at 36, the double-bottom type head (B) bounced off the 34 area, and the right shoulder (C) tested the 38-39 level. Volume had held low on all downthrusts suggesting that the stock was (at least temporarily) oversold. In late August Magma rose above the "neckline" (X) or resistance, thereby "breaking to the upside". At this point many chartists bought the stock.

Because of the precipitous drop already sustained by Magma, the odds favor some sort of correction. How far the move can carry is an unanswerable question. Remembering that the primary trend of the market is down, the most that this writer would do in the situation would be to cover any shorts which might be outstanding in Magma.

Mr. Iain Fraser writes me that he has started a special service which charts the daily price movements and volume of Canadian gold companies. For information write to him at 199 Bay Street, Toronto 1, Ontario, Canada. (There is no cash or other arrangement between Dow Theory Letters and any other service mentioned in these Letters. All information is offered in the interests of subscribers.)

(Written Thursday, August 18th - 11 A.M.)

